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Statement by Mr. Merz

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1. Introduction

The global economy continues to benefit from strong output growth. While the overall outlook remains positive, downside risks have clearly increased. They are compounded with the risk of being complacent due to low long-term interest rates around the globe and no significant inflationary pressures in most countries. The Fund plays a crucial role in reminding members of the possible risks for economic growth. It must also provide guidance and leadership in resolving existing global imbalances.

To fulfill its important role in the international financial system the Fund needs well-defined goals, adequate instruments, and an efficient allocation of internal resources. The Managing Director's medium-term strategy is a good basis for reflecting on these issues. I thank Management and the Executive Board for their work and look forward to concrete decisions tackling the various outstanding questions and then going about the strategy's implementation.

Significant progress has also been made in the area of Fund support to low-income members. It is important that the Fund plays its proper role in the international community's effort to help countries meet the Millennium Development Goals. By promoting macroeconomic and financial stability and sound economic institutions, the Fund contributes significantly to the reduction of poverty.

Considerable work has also been carried out in enhancing the Fund's capacity building ability. In this regard, the Independent Evaluation Office's (IEO) recommendations on Fund technical assistance were particularly useful. I look forward to future work of the IEO.

2. The Global Economy and Financial Markets

The world economy is still expanding at a strong pace. Fortunately, there have not been any surprises since our last meeting. However, today the balance of risks to this expansion is clearly to the downside. Global imbalances have not been reduced, but have even worsened and rapidly climbing oil prices could hit private consumption. Furthermore, in richly valued housing markets, a correction or a marked deceleration of prices may slow overall activity, especially if it is associated with sharply higher interest rates.

Current imbalances reflect a series of diverse and partly unrelated regional developments. Adjustment therefore needs to take place in several countries and regions, including the group of oil-exporting countries. However, I think the IMF mantra regarding the policies necessary in the different regions must be refined. I still believe that a major share of measures should be taken by the US. Clearly, reducing the budget deficit and dealing with the consumption boom that may be partly driven by the bubble in the housing market must be key policy priorities. Yet in addition to that, they must be accompanied by structural measures. The very low US savings rate calls for reforms that improve incentives to save. To deal with longer-term fiscal liabilities, reforms in social security, including health policies, are needed. For Europe and Japan the importance of growth enhancing structural reforms remains relevant. However, this is not sufficient. Fiscal deficits must also be addressed. In particular, while welcoming the recent reform of the Stability and Growth Pact in Europe, I remain convinced that a strict enforcement of the revised Pact will be imperative. Finally, we have now seen encouraging steps in Asia, with China and Malaysia introducing some flexibility in their exchange rates. More should and can be done in this regard. The Fund, as a truly global forum, must play a coordinating role in addressing these global imbalances.

Solid growth and low inflation has also contributed to further strengthening of global financial stability. Also, financial and corporate sector balance sheets have improved in most countries. I welcome that emerging markets have taken advantage of the favorable environment to meet most of their borrowing requirements for this year. By improving debt management, and to the extent that structural reforms have been implemented, they have become increasingly resilient against market disruptions. However, risks have not disappeared. The same benign forces which underpin growth and strengthened global financial stability have also created larger global imbalances. As a result, higher levels of debt have deteriorated household balance sheets. Looking forward, the key risk is an abrupt increase in interest rates, possibly in conjunction with a disorderly correction of global imbalances. In this regard, the rise of oil prices to record highs represents a significant risk to the global economic expansion as it may imply a stronger than anticipated global monetary tightening to prevent second-round effects on wages and prices.

3. Implementing the IMF's Medium-Term Strategy

I warmly welcome the recent efforts to develop a vision of the Fund's medium-term priorities. I am pleased to note that this necessary reflection has now brought about a clearer view of the way forward. While further work will be needed for a longer-term strategy for the institution and its governance and organization, we are now in a position to begin implementing a better prioritization in the three main areas of Fund activities: surveillance, balance of payments lending and capacity building.

Regarding surveillance—the Fund's pivotal activity—efforts need to continue to increase the focus on vulnerabilities and areas of systemic risk across the membership. In order to avoid crises, it will also be important that the Fund continues to advise countries on capital account liberalization. On Fund lending and crisis resolution, the emphasis should be on a consistent application of rules for the access to Fund resources and on the development of exit strategies. Here, more sharply focused incentives could contribute to a way out of the current unsatisfactory situation. In capacity building, we need to develop a more strategic, systematic approach.

Furthermore, the Fund's role in low-income countries needs to be reexamined against the backdrop of further debt relief, and the consequences this will entail for further lending. This will be necessary in order to develop a coherent and sustainable framework for these activities.

As to the institution's governance and organization, it will be necessary to discuss the IMFC's role. In particular, the emphasis should be on how to enable the IMFC to fulfill its central role as a body for longer-term strategic discussions, decision making and guidance. There must also be greater clarity about the fact that it is the Executive Board that sets policy guidelines and monitors their implementation as its day to day business.

A well-balanced participation in the decision making of the Fund is important for the effective functioning of the institution. Past discussions on changing the quota formula have underscored the divergent views on how economic relevance should be measured. Since there is little scope to agree on a new formula, we should use the current metric to assess members' quota shares. In this context, we are ready to work towards an adequate representation across the membership. Representation must continue to reflect the position of countries in the international financial system, and their contribution to financial stability. A consensus on an adjustment of quotas could also include an increase in basic votes to strengthen the representation of low-income countries

Let me now go into further detail on Fund lending, capacity building, and on the Fund's organization.

Improving the Incentive Structure for Fund Lending

The Fund's financing is limited. This should be signaled more clearly and consistently. Past experience shows that there are weaknesses both in the pricing of and the interrelations between the different instruments of Fund credit. These have contributed to unduly frequent exceptional access and to prolonged use of Fund resources. Moreover, the lack of harmonized charges across facilities and the low level of surcharges has opened arbitrage possibilities between different Fund instruments and has resulted in the substitution of market financing by Fund credit. Such debt optimization possibilities are inconsistent with the Fund's objectives to provide temporary financing and to support policies aimed at correcting the underlying problems.

Given the possibility that Fund resources will further diminish over the medium term, consideration should be given to alternative sources of income. I also believe that the discussion on how to enhance our ability to deal with risks associated with its highly concentrated lending needs to continue.

A Strategic Approach to Capacity Building

The Fund has rightly recognized the critical contribution of capacity building to member countries. Its importance is reflected in the increasing budgetary resources allocated to technical assistance (TA). Given the strong demand for additional TA and existing budgetary constraints, it is essential that these services are provided in their most effective way. In this context, I welcome the task force's timely and decisive proposals for implementing the very pertinent TA recommendations of the Independent Evaluation Office (IEO). Clearly defining medium-term TA strategies for countries and putting in place strong monitoring systems are the main elements of a more effective provision of TA.

Strengthening the Fund's Organization

Setting priorities will have consequences for the organization of the Fund, including on the structure of departments and on the composition of staff. I welcome efforts to bring the Fund's internal workings in line with strategic priorities in both these areas. In particular, implementing a strategy will crucially depend on the Fund's staff. For this reason I warmly welcome the comprehensive review of staff employment, compensation and benefits that is currently being conducted. This review needs to produce a thorough analysis of compensation and benefits. Further, it will need to spell out the necessary adjustments that ensure the Fund's ability to recruit and retain the necessary staff with the geographical diversity and high quality called for in the Articles of Agreement. I believe it is important that a new system will have broad support in the Fund's membership.

4. Support for Low-Income Countries

Over the past year, the Fund has been very busy shaping its contribution to the global efforts to achieve the Millennium Development Goals. Furthermore, while the overarching goal of promoting macroeconomic and financial stability through policy advice, capacity building, and financial assistance remains valid, important work has been undertaken to adapt the Fund's instruments to the specific needs of low-income countries. I welcome these efforts, particularly the progress made in establishing a non-financial Policy Support Instrument (PSI). The creation of a new window in the PRGF Trust aimed at assisting low income countries (LICs) in facing exogenous shocks will have to be examined in light of the implications of the G8 debt cancellation proposal.

I welcome the thrust of the G8 debt cancellation proposal as a contribution to the financing of the MDGs. Debt reduction can enhance poverty reduction. From the onset, Switzerland has supported the HIPC initiative based on the idea of debt redution to sustainable levels. I commend the Fund and Bank staffs' hard work to find a way to implement the G8 proposal. But many open issues remain, which have to be resolved in accordance with the rules and principles of the institutions before the initiative can be adopted and implemented. These concern the financial integrity of the institutions, the even-handed treatment of all low-income members, prudential safeguards, and assuring that an excessive debt build-up will not reoccur.

In my view, the G8 proposal has far-reaching consequences for the Fund's role in LICs. In particular, the Fund's future financial assistance through the PRGF has to be assessed in light of the proposal. Specifically, I expect the demand for PRGF resources to be lower in the future: First, LICs have made great strides in achieving macroeconomic stability and debt sustainability. The PRGF and the HIPC initiative have been instrumental in this regard. Their success implies that they will not be needed indefinitely. Second, because of the achievements in stabilization, the new surveillance-based PSI will increasingly substitute for PRGF arrangements. And finally, after the cancellation of PRGF debt, the need for refinancing will have dramatically decreased. Accordingly, the focus of Fund activities in LICs will increasingly shift from financing to surveillance and capacity building.

Once we have analyzed these implications and drawn our conclusions, and once the new instruments including the new debt sustainability framework are put to use, the process of adapting the Fund's toolkit will be concluded. What we will still need to do then is to clearly position the Fund in the global development partnership. The great needs of LICs and development partners have frequently raised unrealistic expectations vis-à-vis the Fund. I would thus welcome a more clearly defined role for the Fund, as foreseen by the medium term strategy. This would allow the Fund to find its proper place in this partnership. This in turn would make the Fund a more reliable actor and make room for a clearer division of labor with other partners.